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No. 71-368

Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1971

JACK E. GOLSEN and SYLVIA H. GOLSEN,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

ERWIN N. GRISWOLD,
Solicitor General,

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OPINIONS BELOW

The opinion of the Tax Court (Pet. App. xi-xxxv) is reported at 54 T.C. 742. The opinion of the court of appeals (Pet. App. i-x) is not yet reported.

JURISDICTION

The judgment of the court of appeals was entered on June 18, 1971. The petition for a writ of certiorari was filed on September 13, 1971. The jurisdic-

tion of this Court is invoked under 28 U.S.C. 1254 (1).

QUESTION PRESENTED

Whether purported loans from an insurance company to petitioner Jack E. Golsen, lacked economic substance—serving no purpose other than to convert premium payments for insurance into interest payments for tax purposes—with the result that the amounts in issue were not deductible "interest on indebtedness" within the meaning of Section 163(a) of the Internal Revenue Code.

STATUTE INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

> SEC. 163. INTEREST.
>
> (a) *General Rule.*—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * *

STATEMENT

On January 31, 1962, the Western Security Life Insurance Company (Western) issued to petitioner [1] 20 "executive special" life insurance policies, each having a face amount of $50,000. These policies named petitioner as the insured, his wife as the primary beneficiary, and the couple's three children as

[1] References to petitioner are to Jack E. Golsen. Sylvia H. Golsen is a party only because a joint income tax return was filed.

contingent beneficiaries. On their face, the policies appeared to be whole life policies which provided for an aggregate premium of $68,180 per year for the first 20 years and $18,180 per year thereafter. (Pet. App. ii, xxv.)

The insurance program operated as follows:

1. In the first year, petitioner "paid" to Western the first year premium ($68,180) and the present value of the next four years' annual premiums, discounted at three percent ($253,431.90), for a total of $321,611.90. The prepayment when supplemented by the interest to be earned thereon was designed to be sufficient to pay the next four annual premiums as they became due. Petitioner also "paid" Western $12,441.40 as "interest" on the total amount "borrowed" from Western under terms described immediately below. (Pet. App. iii, xv, xix.)

2. Also during the first year, petitioner "borrowed" $311,033.90 from Western at annual "interest" of four percent. The "loan" consisted of the entire first year cash surrender value of the policies ($50,000), which petitioner used to pay the greater part of the first year's premium, and an additional larger sum ($261,033.90), which he used to establish the prepaid premium fund. (Pet. App. iii, xv, xix-xx.)

3. In each succeeding year, petitioner would replenish the prepaid premium fund by "prepaying" the premium (discounted at three percent) due four years later ($60,577.90). To do so, he would increase his "loan" by "borrowing" the entire increase in

cash surrender value (which was always greater than the $60,577.90 added to the prepaid premium fund), and would use the "borrowed" amount to pay the addition to the prepaid premium fund in full and a portion of the annual four percent "interest" charge on his increasing "indebtedness" to Western. As a result of this planned "borrowing" the policies at no time had a cash surrender value. (Pet. App. iii-iv, xv-xvi, xxii-xxiii.)

Thus, after the first year, petitioner would incur no out-of-pocket cost for insurance coverage, and the entire amount of his actual cash payment would be characterized as "interest." At issue here is the deductibility of these payments. If deductible, then depending on petitioner's tax bracket, the actual cost of the insurance death benefit protection provided under the insurance contract would either be nominal in amount, or, under ideal circumstances (where petitioner was in a sufficiently high tax bracket), would be zero, with petitioner actually making a net profit on the transaction because the tax benefit of the interest deduction exceeded his out-of-pocket cost. The attractiveness of the arrangement to petitioner was enhanced because he was never personally liable on any of his "borrowing," and because the "loans" could be cancelled at any time without further cash payment, as was, in fact, done on January 26, 1967, by offsetting book entries on Western's books. (Pet. App. iv-v, xvi-xvii, xxv-xxvii.)

Based on the expert testimony of an actuary, the Tax Court held that the annual premium was set at an artifically high level to create an abnormally high

cash surrender value; that petitioner's out-of-pocket costs constituted, in substance, premiums for term insurance in an amount equal to the excess of the face amount of the policies over the stated cash surrender value thereof; and that the amounts in issue therefore were not deductible "interest on indebtedness" within the meaning of Section 163(a) of the Internal Revenue Code, p. 2, *supra*. (Pet. App. v-vi.) The court of appeals affirmed (Pet. App. xiii-xiv).

ARGUMENT

The decision below is correct. Although there is a conflict of decisions, the issue presented has been rendered moot with respect to contracts entered into after August 6, 1963, by amendments to Section 264 of the Internal Revenue Code enacted by the Revenue Act of 1964.

1. Expert testimony at trial established that petitioner's out-of-pocket costs were actuarially no more than the amount required to support or pay for the insurance death benefits actually available under the policies, considering the fact that the policies at all times lacked cash surrender value. It follows, therefore, that the payments designated as "interest" were, in substance, nothing more than premiums for term insurance coverage, and were not payments for the use of borrowed money. See *Deputy* v. *du Pont*, 308 U.S. 488, 497-498; *Old Colony Railroad Co.* v. *Commissioner*, 284 U.S. 552, 560. The decision below that the insurance program lacked economic substance is supported not only by expert ac-

tuarial testimony, but also by the fact that petitioner paid "interest" at four percent to obtain the use of funds which were originally his and which he had "loaned" to the insurance company at three percent. Under similar circumstances, this Court has held that interest deductions are not available. See *Knetsch* v. *United States*, 364 U.S. 361.

2. The decision here is in conflict with that of the Fifth Circuit in *Campbell* v. *Cen-Tex, Inc.*, 377 F. 2d 688. But, despite the conflict, the issue is not of sufficient importance to warrant review by this Court. Legislation applicable to insurance contracts purchased after August 6, 1963—the contracts here and in *Cen-Tex, Inc.* were purchased before the cut-off date—specifically bars an interest deduction where, as here, an amount is paid "pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise)." Section 264(a)(3) of the Code, as added by Sec. 215(a)(1) Revenue Act of 1964, P.L. 88-272, 78 Stat. 55. The Internal Revenue Service advises that, in addition to the instant case, there are presently pending, judicially and administratively, similar cases involving only eight taxpayers and approximately $400,000 of tax, which are not subject to the 1964 legislation.[2]

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[2] One of these is *Woodson-Tenant Laboratories, Inc.* v. *United States*, 71-1 U.S.T.C., par. 9216 (W.D. Tenn.), pending on the government's appeal in the Sixth Circuit (No. 71-1371), in which the district court followed the Fifth Circuit's decision in *Cen-Tex, Inc.*

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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